Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HCT:NEW:1:TL-N-6329-00
AAmmirato

date: JAN 1 9 2001

to: [redacted], Team Manager, [redacted]

from: Associate Area Counsel, LMSB

Subject: [redacted]

This advisory corrects the advisory issued on January 3, 2001. On page 10 of the advisory, the last two sentences should read, "[S]pecifically, [redacted] would increase its pool of foreign taxes in the appropriate section 904(d) 'basket'. <u>See</u> Temp. Reg. 1.905-3T(d)(3)(ii). Conversely, the increase of foreign taxes would decrease [redacted]'s pool of earnings and profits. <u>Id</u>."

Since the discussion may relate to adjustments in future audit cycles, please incorporate the change into the January 3, 2001 advisory.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

If you have any questions please contact attorney Anthony Ammirato at (973)645-2539.

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/s/ William F. Halley

By: ______________________

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Internal Revenue Service

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date: JAN 03 2001

to: [redacted], Team Manager, [redacted]

from: Associate Area Counsel, LMSB

Subject: [redacted]

The following is advice concerning how examination should proceed with adjustments for [redacted] for the [redacted] taxable year. The case is being conducted as a simultaneous examination with the U.K. Inland Revenue. The U.K. Inland Revenue has proposed adjustments which may impact foreign tax credits claimed by the taxpayer in the U.S. The taxpayer is challenging the proposed adjustments. , (b)(5)(AWP), (b)(5)(AC) [redacted].

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FACTS

[redacted] ("taxpayer") owns [redacted]% of [redacted], which owns [redacted]% of [redacted]. [redacted] is a holding company and is not directly engaged in [redacted]. In addition to [redacted], [redacted] owns several other U.K. subsidiaries which are involved in [redacted]. [redacted] is a member of [redacted]'s consolidated group and is a dual resident of the U.S. and U.K. [redacted] is a resident of the U.K.

On [redacted], a $[redacted] distribution was paid by [redacted] to [redacted] and redistributed to [redacted] on the same day. The funds originated with [redacted] and were produced through the operations of [redacted]. The following day, [redacted] returned the $[redacted], plus interest to [redacted]. [redacted] passed $[redacted] back to [redacted] in installments over a period from [redacted] through [redacted]. In return for the $[redacted], [redacted] distributed "convertible loan stock" to [redacted].

During the tax year at issue, United Kingdom imposed an Advanced Corporate Tax ("ACT") on dividends paid by U.K. corporations as part of its partially integrated tax system.[1] Pursuant to the ACT provisions, when a "qualifying distribution" is made to shareholders, the distributing corporation is obligated to pay to the United Kingdom Inland Revenue an "ACT" equal to a specified portion of the distribution. See Income and Corporate Taxes Act, 1988, sec. 14 (1)(Eng.). If a controlled subsidiary makes a distribution to a parent, the parties can elect whether the subsidiary will pay ACT on the distribution or the parent will pay ACT on subsequent distributions of such funds. See Id. sec. 247(4).

Generally, the distributing corporation is entitled to a credit against mainstream tax equal to the amount of the ACT ("offset"). See Id. sec. 239(1). If the offset exceeds the amount of the corporation's mainstream tax, the corporation can carry the corporate offset back six years or forward indefinitely. See Id. sec. 239(3) and (4). A corporation can also elect to allocate the offset to one or more of its "controlled subsidiaries" (51% or more of ordinary share and economic ownership). See Id. sec. 240(1). A U.K. shareholder, upon receipt of the dividend, becomes entitled to a credit against its individual taxes ("ACT Refund"). See Id. sec. 231(1). A shareholder receives a cash refund to the extent that the ACT payment exceeds its tax liability on the distribution. In the absence of a tax treaty, the shareholder

[1] The U.K. repealed the ACT effective April 6, 1999. See Rev. Proc. 2000-13, I.R.B. 2000-6 (Jan. 19, 2000).

credit is not available to nonresidents of the United Kingdom. See Id.

The U.S.-U.K. Tax Treaty provides that in the case of a dividend paid by a U.K. corporation to a U.S. corporation, which holds a 10% or more ownership interest in such U.K. corporation, the U.S. shareholder is entitled to a refund of the ACT paid on the distribution equal to ½ of the amount which a U.K. individual would be entitled to ("ACT refund"). U.S.-U.K. Tax Treaty, Article 10(2)(a)(i). The refund is subject to a withholding tax in U.K. not to exceed 5% of the aggregate of the refund and dividend. Id. The aggregate amount of the refund from the U.K. Inland Revenue and the amount of the dividend (without reduction by the 5% withholding) is treated as a dividend for U.S. tax credit purposes. Id. at Article 10(2)(a)(iii). Therefore, a distribution to a U.S. shareholder reduces the overall U.K. tax burden since the mainstream tax is offset by the ACT and the U.S. shareholder receives an ACT refund.

The 5% withheld under Article 10(2)(a)(i) on the refund from U.K. Inland Revenue is treated as an income tax imposed on the receipt of the dividend. Id. at Article 23(1)(b). That amount of tax credit referred to in paragraph (2)(a)(i) of Article 10 (dividends) which is not paid to the U.S. corporation, but to which an individual resident in the United Kingdom would have been entitled had he received the dividend, is treated as an income tax imposed on the corporation paying the dividend. Id. at Article 23(1)(c). Therefore, the U.S. parent is entitled to a "deemed paid" foreign tax credit for such tax.

A dual-resident corporation can not claim a refund of advanced corporate tax with respect to a dividend received from a corporation which is a resident of the United Kingdom. See U.S.-U.K. Tax Treaty, Article 1(2). The dual resident corporation is treated as a resident of neither contracting state for purpose of the Treaty. See Tech. Explan. of Article 1(2). However, a United States resident receiving dividends from a dual-resident corporation which, under the internal laws of the United Kingdom, is a resident of the United Kingdom, will qualify for the refunds or credits of advanced corporate tax under article 10 paragraph 2. Id.

An issue arises under the U.S.-U.K. Tax Treaty where a U.K. corporation makes a "qualifying distribution" to a U.S. shareholder for which an ACT is paid and the U.K. corporation elects to allocate the offset to one of its controlled subsidiaries. As discussed above, normally, the portion of the ACT not refunded to the U.S. shareholder is treated as an additional tax imposed on the payor corporation pursuant to

Article 23(1)(c). This generally would allow the U.S. shareholder to claim deemed paid tax credits under section 902 for the "additional tax" imposed on the payor corporation. However, where the offset is allocated to a controlled subsidiary of the foreign corporation, the Service has taken the position that the subsidiary is the "payor corporation" under Article 23(1)(c). Therefore, foreign tax credits on the distributions from the foreign parent would not be allowed for the "additional tax". See Rev. Proc. 80-18, 1980-1 C.B. at 625. In Xerox Corp. v. United States, 41 F.3d 647 (Fed. Cir. 1994), rev'g. 14 Cl. Ct. 455 (1988), the Federal Circuit Court held that under the U.S.-U.K. Treaty, a foreign tax credit was allowable for the unrefunded portion of the ACT without regard to the use of the corporate offset. The Tax Court reached the same conclusion in Compaq Computer Corp. v. Commissioner, 113 T.C. No. 25 (1999). The Court in Compaq reasoned that the ACT is levied on the corporation that pays the dividend (therefore, additional tax is treated as imposed on such corporation) regardless of whether that corporation or its subsidiary will make use of the corporate offset.

In our facts, instead of paying ACT on the distribution to [redacted], taxpayer elected to have [redacted] pay ACT on the redistribution of the $[redacted] to [redacted] pursuant to Income and Corporate Taxes Act, 1988, sec. 247(4)(Eng.). An ACT in the amount of $[redacted] was paid to the U.K. Inland Revenue. The election to have the ACT imposed on the redistributions was motivated by the inability of [redacted] to receive an ACT refund under the U.S.-U.K. Tax Treaty due to its status as a dual resident. See U.S.-U.K. Tax Treaty, Tech. Explan. Article 1(2). However, as the payor of the distribution, [redacted]'s status as a dual resident does not prevent [redacted] from claiming ACT refunds under the U.S.-U.K. Treaty. Id. Pursuant to Income and Corporate Tax Act, 1988, sec. 240(1)(Eng.), [redacted] elected to allocate the "mainstream corporate offset" to [redacted]. Pursuant to Article 10(2)(a)(i), [redacted] submitted claims with the U.K. Inland Revenue for an ACT refund. The Inland Revenue denied the claim. The U.K. Inland Revenue has two alternative arguments in support of its position:

1) Ramsey argument. The argument is similar to our economic substance or "step transaction doctrine argument" in the U.S. The U.K. disregards a flow of cash where a) there is a preordained series of transactions; and b) steps were inserted that have no business purpose apart from the avoidance of tax. The U.K. would disregard the payments to [redacted] and [redacted], therefore, there would be no ACT liability and no ACT refund. Since there would be no ACT liability, taxpayer would not be entitled to foreign tax credits in the U.S.

2) Argument pursuant to Schedule 7 of the Finance Act of 1997. The U.K. would treat the distribution as a "foreign income dividend". Since U.K. individuals are not entitled to a tax credit in respect of ACT paid on foreign income distributions, Article 10(2)(a)(i) of the U.S.-U.K. Tax Treaty providing for an ACT refund would not apply. Therefore, taxpayer would be subject to the ACT but would not be entitled to an ACT refund. As such, taxpayer would still be entitled to a foreign tax credit in the U.S. for the ACT liability.

The taxpayer treated, pursuant to U.S.-U.K. Tax Treaty Article 23(1)(c), the entire unrefunded ACT as a tax imposed on [redacted]. As discussed above, the Service has taken the position that where the "mainstream offset" is allocated to a subsidiary, the subsidiary is considered to be the payor of the additional tax (equal to the amount of the unrefunded ACT) for purposes of claiming foreign tax credits under Article 23(1)(c) of the U.S.-U.K. Tax Treaty. Therefore, any unrefunded ACT would be considered an additional tax imposed on [redacted].

Generally, under the U.S.-U.K. Tax Treaty, the foreign tax credit claimed for the "additional tax" under Article 23(1)(c)(unrefunded ACT), is a deemed paid credit under section 902 since the unrefunded ACT is treated as a tax imposed on the payor foreign corporation and not the U.S. shareholder. However, in our facts, [redacted], the payor corporation, is a dual resident of the U.S./U.K. and is a member of the [redacted] consolidated group. Therefore, the consolidated group claimed a direct foreign tax credit for the $[redacted] unrefunded ACT treated as an "additional tax" imposed on [redacted].

ISSUE

Whether taxpayer should be tentatively allowed a foreign tax credit for the ACT payment.

Conclusion: Until the issue in the U.K. is resolved, the audit cycle should remain open in the U.S. Alternatively, the foreign tax credit for the ACT should be denied.

DISCUSSION

Whether the taxpayer is ultimately entitled to the foreign tax credit for the $[redacted] ACT payment depends on how the issue is resolved in the U.K. If the U.K. Inland Revenue succeeds pursuant to the Ramsey argument, there would be no ACT liability. Therefore, Taxpayer would not be entitled to the direct foreign tax credit for the ACT. However, since the "mainstream tax offset" would not apply, [redacted] would be assessed additional mainstream tax. This would have an impact on taxpayer's indirect foreign tax credits claimed pursuant to section 902 or 960.

In the event that the U.K. Inland Revenue succeeds pursuant to the "foreign income dividend" argument, then the taxpayer would be subject to the ACT. However, taxpayer would not be entitled to an ACT refund pursuant to the U.S.-U.K. Tax Treaty. Therefore, Taxpayer would be entitled to the direct foreign tax credit of $[redacted]. Since it is uncertain at this time whether the U.K. Inland Revenue will be successful in its challenge (or pursuant to which argument), we recommend, as a first option, that the audit team keep the tax year open. This would provide the Service with the ability to monitor the progress of the case in the U.K. since the audit is being conducted as a simultaneous examination.

As a second option, we would recommend denying the foreign tax credit for the ACT liability. Any deemed paid credits under section 902 or 960 would need to be computed based on [redacted]'s post 1986 foreign taxes which does not include any portion of the ACT paid in connection with the [redacted] distribution. Another option would be to deny a portion of the foreign tax credit which relates to the portion of the ACT refund the taxpayer would normally be entitled to pursuant to the U.S.-U.K. Tax Treaty.

A third option would be to allow the foreign tax credit for the ACT and rely on an adjustment under section 905(c) in the event that the ACT liability in the U.K. is reduced or eliminated. (b)(5)(AWP) [redacted].

I. Denying the Foreign Tax Credit Claimed for the ACT Payment.

In general, a foreign tax credit is allowed under section 901 for the amount of income tax that is paid by the taxpayer. However, "[a]n amount is not a tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven." Treas. Reg. 1.901-2(e)(2). In addition, a payment of tax to a foreign country which is noncompulsory will not result in any foreign tax credit. Treas. Reg. 1.901-2(e)(5)(i). A payment is noncompulsory when it exceeds a taxpayer's true tax liability under foreign law. The amount paid does not exceed the taxpayer's liability if two conditions are met: 1) taxpayer must determine the amount paid in a manner consistent with a reasonable interpretation and application of the foreign law to reduce over time the taxpayer's expected foreign tax liability; 2) taxpayer must exhaust all effective and practical remedies, including invocation of competent authority procedures under tax treaties, to reduce over time the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Id.

In our facts, the U.K. Inland Revenue has made a determination pursuant to the Ramsey doctrine that there is no ACT liability. Therefore, the payment of the ACT is noncompulsory and taxpayer is not entitled to a foreign tax credit. Furthermore, since the taxpayer has not exhausted "all effective and practical remedies" to challenge the U.K. Inland Revenue's position and reduce its tax burden in the U.K. (The ACT payment and the corresponding ACT refund and mainstream offset reduces the overall U.K. tax burden), the ACT payment is a noncompulsory payment in the U.K. and the foreign tax credit is disallowed pursuant to Treas. Reg. 1.901-2(e)(5)(i). In addition, an argument can be made that the foreign tax credit should be denied pursuant to Treas. Reg. 1.901-2(e)(2) since it is "reasonably certain" that the entire ACT will be refunded.

As an alternative position, the Service could deny a portion of the foreign tax credit claimed for the ACT in proportion to the ACT refund the taxpayer would be entitled to under the U.S.-U.K. Treaty. The taxpayer has "not exhausted all effective and practical remedies" to receive the ACT refund pursuant to the Treaty. In addition, it can be argued that it is "reasonably certain" that a portion of ACT will be refunded pursuant to the Treaty.

Where a taxpayer pays a foreign tax then contests the liability, it has been held that the taxpayer is nevertheless entitled to a foreign tax credit. I.B.M. v. United States, 97-2 USTC ¶ 50,602; See also Rev. Rul. 70-290, 1970-1 C.B. 160; Rev. Rul. 84-125, 1984-2 C.B. 125. In I.B.M. the government argued that public policy mandates that a taxpayer must first exhaust all remedies in the foreign country prior to being entitled to a foreign tax credit in the U.S., regardless of whether the tax was actually paid. Id. A taxpayer may be indifferent whether a tax is paid to the U.S. or a foreign country. Without the exhaustion of remedies requirement, a taxpayer may be content to receive the foreign tax credit in the U.S. and forgo litigation in the foreign country. In essence the foreign tax credit turns into "...nothing more than a subsidy to foreign government..." Id.

The Court in I.B.M. acknowledged that the preamble to the final regulations expressly states that Rev. Rul. 70-290(providing that a taxpayer may claim a foreign tax credit for the year in which it pays the foreign tax, notwithstanding the fact that the taxpayer continues to contest the liability for the tax) continues to represent the position of the Service. The Court agreed that the government presented sound policy reasons for requiring a taxpayer to exhaust all litigation remedies before being entitled to a foreign tax credit. However, the Court pointed out that the regulations and applicable Revenue Rulings do not reflect the public policy concern. As such, the Court ruled that the taxpayer was entitled to the foreign tax credit for the taxes paid. The Court cited section 905(c) as the mechanism by which adjustments may be made to the claimed foreign tax credits in the event that the taxes were refunded in the foreign country.

Unlike in our facts, in I.B.M. it was the taxpayer who was contesting the liability. In our facts, it is the U.K. Inland Revenue who is challenging the liability for the ACT pursuant to the Ramsey doctrine. Taxpayer has taken the position that the ACT applies and they are entitled to an ACT refund pursuant to the U.S.-U.K. Tax Treaty. Unlike in I.B.M., the U.K. Inland Revenue has made a determination that taxpayer is not subject to the ACT. This distinction may be sufficient to distinguish our facts from I.B.M. and the Revenue Rulings. Therefore, we recommend that the entire, or a portion, of the foreign tax credit claimed for the ACT be denied pursuant to Treas. Regs. 1.901-2(e)(5)(i) and 1.901-2(e)(2).

II. Section 905(c) Foreign Tax Redetermination

As an alternative to keeping the cycle open or denying the foreign tax credit, the credits can be allowed and we could rely on section 905(c) to make the proper adjustments if there is a change in the U.K. tax liability. , (b)(5)(AWP) [redacted].

Currently, the U.K. Inland Revenue is relying on two alternative arguments. Under the Foreign Income Dividend argument, the dividend is respected, however the taxpayer is not entitled to an ACT refund under the U.S.-U.K. Tax Treaty. Therefore, the taxpayer would be entitled to a foreign tax credit for 100% of the ACT in the U.S. (which is the taxpayer's position on the tax return). , (b)(5)(AC), (b)(7)a [redacted].

Under the Ramsey argument the entire distribution would be disregarded and there would be no ACT liability. The U.K. would refund the entire ACT payment to [redacted] and would assess additional mainstream tax. Therefore, the taxpayer would not be entitled to a foreign tax credit for any portion of the ACT. As such, the taxpayer would have an incentive to challenge the Ramsey argument regardless of whether the foreign tax credit for the ACT is allowed in the U.S.

, (b)(5)(AC), (b)(5)(AWP) [redacted]. The following is a discussion of section 905(c) and the regulations in the event that a section 905(c) adjustment becomes necessary.

Section 905(c) and the regulations thereunder provide for adjustments to foreign tax credits where a "foreign tax redetermination" occurs. Temp. Treas. Reg. 1.905-3T(c). A "foreign tax redetermination" may occur in any of the following three basic patterns: 1) Where there is a refund of foreign taxes; 2) where foreign taxes change between accrual and payment (in units of foreign currency); and 3) where there is a change in the exchange rate between the accrual and payment date (even though the foreign taxes stay the same in foreign currency units). Temp. Treas. Reg. 1.905-3T(c). Any of the above event may result in a change to the allowable U.S. foreign tax credits requiring an adjustment under section 905(c).

There are three methods of adjusting U.S. taxes upon a foreign tax redetermination: 1) Service recomputes U.S. tax due for the year in which the foreign tax credit was first claimed, resulting in an income tax deficiency or refund; 2) Where there is a "de minimis" change in foreign taxes paid, a taxpayer adjusts foreign tax credits in the current year, not the original year; 3) where the foreign tax redetermination impacts section 902 or 960 indirect credits, taxpayer may adjust pools of foreign taxes and earnings. This affects foreign tax credits in current and future years but produces no deficiency or refund of U.S. taxes. Temp. Treas. Reg. 1.905-4T(c)(2).

Where a foreign tax redetermination affects direct foreign tax credits claimed in earlier year, a retroactive adjustment generally must be made in the year the credits were claimed requiring a "redetermination of U.S. tax liability". Temp. Treas. Reg. 1.905-3T(d)(1). The result will be a deficiency or refund of taxes. Where a "foreign tax redetermination" requires a "redetermination of U.S. tax liability" taxpayer must notify the Service. Temp. Treas. Reg. 1.905-4T(a); 1.905-4T(b)(1). The

Service is notified by the taxpayer filing Form 1120X. Id. If the taxpayer fails to notify the Service before the date set by regulations a penalty may apply. See Temp. Treas. Reg. 1.905-4T(c)(3); section 6689(a); Treas. Reg. 301.6689-1(b)(penalty is generally 5% of the deficiency per month, not to exceed 25% of the resulting U.S. tax deficiency). The normal deficiency procedures do not apply with respect to the amount due. Section 905(c); Temp. Treas. Reg. 1.905-4T(b)(1). Taxpayer must pay any tax deficiency resulting from a redetermination of U.S. tax liability on Notice and Demand from the Service. Id.

Where a foreign tax redetermination affects indirect foreign tax credits claimed under section 902 or 960, generally, a redetermination of U.S. tax liability is not required. Temp. Treas. Reg. 1.905-3T(d)(2)(i). Instead, the pools of foreign taxes and earnings and profits are adjusted under specific rules. Temp. Treas. Reg. 1.905-3T(d)(2)(i). Taxpayer must attach a special notice to the return for the taxable year that includes the end of the foreign corporation's year in which the foreign tax redetermination occurs. Temp. Treas. Reg. 1.905-3T(d)(2)(iii).

In our facts, in the event that the U.K. is successful in arguing that Ramsey apples, the entire ACT would be refunded. Assuming that we allow the full foreign tax credit for the ACT, there would be a "foreign tax redetermination" under section 905(c)(since there would be a refund of foreign taxes). Since the foreign tax redetermination would impact a direct foreign tax credit, a redetermination of U.S. tax liability would be made for the [redacted] taxable year.[2] As discussed above, a finding that the taxpayer is not liable for the ACT, would result in additional assessment of mainstream tax on [redacted] (since mainstream tax offset would not apply). This would constitute a "foreign tax redetermination" which would impact deemed paid credits under section 902 or 960 claimed by the taxpayer. There would not be an adjustment to the U.S. tax liability in [redacted] for adjustments to deemed paid foreign tax credits. [redacted]'s pools of foreign taxes and earnings and profits would be adjusted in the year of the "foreign tax redetermination". Temp. Treas. Reg. 1.905-3T(d)(2)(ii)(B). Specifically, [redacted] would reduce its pool of foreign taxes in the appropriate section 904(d) "basket". See Temp. Reg. 1.905-3T(d)(3)(ii). Conversely, the refund of foreign taxes would increase the [redacted]'s pool of earnings and profits. Id.

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[2] In the event that the taxpayer is successful and receives a refund for ½ of the ACT pursuant to the Treaty, a redetermination of U.S. tax liability would be required to account for the portion of the ACT refunded.

If you have any questions please contact attorney Anthony Ammirato at (973)645-2539.

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By: /s/ WFH
WILLIAM F. HALLEY
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Attachment

cc: Territory Manager